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09/25/2007

Summary to the Legal Report to The Blue Ribbon Commission on Public Employees Retirement Systems of Kentucky

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SEPTEMBER 25, 2007

Summary

The attached report provides an overview of the law governing the concept of "inviolable contract," generally and with respect to the Public Employee Retirement Systems in Kentucky, including both defined benefit pension and medical benefits for various groups of Kentucky public employees. This report contains a detailed discussion of the law in this area, both within Kentucky and throughout the United States.

With respect to **pension benefits**, courts around the United States have chosen a variety of approaches to decide whether — and the extent to which — the legislative or administrative actions of state or local government employers impermissibly impair rights to receive pension benefits held by public employees or retirees. Although historically courts used to regard pension benefits as an employer's "gratuity" that could be reduced or eliminated at the will of the employer, currently the vast majority of states reject the gratuity theory. Instead they have adopted one of several forms of a "contract," "promissory estoppel," or "property" legal theory to protect pension benefits from impairment by subsequent employer action. Courts examine closely the language of state statutes and constitutional provisions to decide if the legislature intended pension benefits to be a contractual right held by public employees and retirees, and to decide whether particular actions (such as extending periods of qualifying, capping certain benefits, or altering standards of disability) constitute sufficient impairment to render the actions invalid, or whether there is a sufficient "pension-system-related" reason for the change to justify it.

The Kentucky statement of intent is one of the strongest among the states. Its statute expressly states that pension benefit laws "constitute an inviolable contract of the Commonwealth and the benefits provided therein shall . . . not be subject to reduction or impairment by alteration, amendment, or repeal." *See*, *e.g.*, KRS 61.692. Thus, under Kentucky law, pension benefits for public employees and retirees are a contractual right, and those benefits may not be reduced or terminated by the legislature retrospectively. Opinions of the Kentucky Attorney General, sought by legislators or retirement officials to test proposed legislation

affecting pension benefits, have applied the "modified contract" theory exemplified by other states, especially California (whose cases are often cited), that permitted flexibility but not current or future net diminutions of benefits.

The extent to which the Kentucky public employer may otherwise intervene — short of "reduction or impairment" — was also addressed in *Jones v. Board of Trustees*, 910 S.W.2d 710 (Ky. 1995), where the Kentucky Supreme Court "recognize[d] that the retirement savings system has created an inviolable contract between KERS members and the Commonwealth, and acknowledge[d] that the General Assembly can take no action to reduce the benefits promised to participants." *Id.* at 713. However, the Court held in that case that the actions of the Governor and General Assembly in declining to follow the retirement system's recommendations to increase the state's contribution to the system, and instead to maintain the previous rate of the state contribution, was not an unlawful impairment of the KERS members' inviolable contract rights because there was "no showing that the retirement benefits promised to KERS members have been or will be infringed by the failure to adopt the Board's recommendations." *Id*. That condition has since changed in part due to the more substantial underfunding of the systems. What the Kentucky Supreme Court will do if that status should be challenged before it is an open question.

With respect to **medical benefits**, there is a split of authority among the states on the issue whether health insurance or other medical benefits are part of the retirement benefit conferred by public retirement systems. Some jurisdictions hold that medical benefits are part of the retirement package, while others hold that medical benefits do not create a vested contractual right. For state statutes that confer medical benefits or health insurance for public employees and retirees, courts will examine the wording of the statutes closely to determine precisely what benefits have been promised and at what cost. Courts outside Kentucky have held, for example, that laws calling for a medical insurance program for retirees do not necessarily give retirees a vested right to health care free of charge or free from increases in fees over time. Almost all of

the case law in this area is from outside Kentucky, and the Kentucky Supreme Court, at least in *Jones*, has shown some caution in following case law from other jurisdictions.

The Kentucky statutes provide that medical benefits are included as part of the "inviolable contract" of the Commonwealth, with the exception that benefits "provided to a member whose participation begins on or after July 1, 2003, shall not be considered as benefits protected by the inviolable contract." See, e.g, KRS 61.702(8)(d). Thus, employees hired on or after July 1, 2003, do not have a contractual right to medical benefits, while employees hired before that date do have such a right.

The extent to which the Kentucky legislature may modify the medical benefits that are presently conferred by statute to employees hired before July 1, 2003, has not been determined by the Kentucky courts. Any modification that is found to reduce those benefits could be held to constitute an unlawful impairment of the "inviolable contract, " but there is no Kentucky authority beyond statutes from which to determine what level or amount of medical benefit is provided and how it may be modified to accommodate cost to employer, cost to employee, and availability. A relation between the respective retirement system provisions for health insurance coverage (in each of which the inviolable contract provision is incorporated by explicit cross-reference) and the specifications for health coverage (which are not cross-referred) has been assumed without discussion in pending litigation that has appeared at the appellate level twice, but is not citable authority.